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C O N F I D E N T I A L SECTION 01 OF 02 SHANGHAI 000499

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E.O. 12958: DECL: 11/14/2033

TAGS: [ECON](#) [EFIN](#) [EINV](#) [EWWT](#) [PGOV](#) [PREL](#) [CH](#)

SUBJECT: SHANGHAI STOCK EXCHANGE OFFICIAL HOLDS DIM VIEW OF LOCAL ECONOMY

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U.S. Consulate General, Shanghai, Dept. of State.  
REASON: 1.4 (d), (e)

¶1. (C) Summary. A well-placed Shanghai financial professional, James Liu of the Shanghai Stock Exchange (SSE), offered a series of candid views on Shanghai's economic prospects, in particular the real estate sector, Chinese stocks, and the U.S. financial bailout plan. Liu is as critical of Shanghai's ability to bolster short-term growth as he is of U.S. officials' ability to efficiently handle the subprime loan crisis. End summary.

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Shanghai's Economy Facing Multiple Challenges  
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¶2. (C) At an October 22 meeting with Econoff, SSE Executive Vice President James Liu, a long-time Consulate contact who is a U.S. citizen (strictly protect), offered a particularly negative assessment of Shanghai's economic prospects. Liu said that Shanghai is in an especially difficult position at present because all its key industries are down: a) the financial market (Note: The SSE as of November 13 had lost 68% of its overall value compared with its peak on October 16, 2007. End note.); b) real estate; c) exports; and d) shipping.

¶3. (C) Liu emphasized that these challenges could not be easily addressed, because they are interrelated with each other and the global financial crisis. Export growth is slowing in light of lower overseas demand, which in turn has slowed imports of related components and raw material inputs. For Shanghai, the greater direct impact is on the shipping industry, with lower trade volumes affecting port development plans.

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Real Estate is Reaching a Breaking Point  
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¶4. (C) A fall of another 20-30 percent in real estate values would precipitate a financial crisis, said Liu. The weakest link is real estate developers, who are succumbing to cash flow difficulties as they attempt to juggle land holding portfolios, construction costs, and falling home buyer demand. Liu said that developers with large land reserves, in particular, have problems: the past model has been to acquire land-use rights from a local government, use this as collateral to finance initial construction, and then sell units to complete the financing once the building is partially completed. The current

downturn in the housing market is squeezing developers in two ways: a) they may lose their land-use rights because ground has not yet been broken on the project (Liu said this period could be up to three years if various extensions are applied); b) unit sales prices are under costs, and the developer cannot recoup investments. In addition to these property developer problems, Liu also said that China is not necessarily immune to homeowner defaults on mortgages, even though the "loss of face" factor may delay this move for most homeowners.

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Stock Market Set for a Cold Winter  
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15. (C) Liu would not venture a guess as to when the slump in the Shanghai Stock Market would end. Speaking near the end of the month-long October reporting period for listed companies' third quarter results, Liu said that most companies with good earnings reports file early in the reporting period, while those with poor earnings reports tend to wait until the final days. China's third quarter GDP growth of 9 percent was a shock to investors, said Liu, implying that this was a precursor to further problems for corporate profits.

16. (C) One bright spot that Liu sees is foreign direct investment (FDI) in China, which he implied could help support local stock markets. FDI continues to rise despite the current fall in Chinese stocks, noted Liu. In his opinion, new FDI flows could come from previously uncommon sources, in particular Middle Eastern countries.

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SHANGHAI 00000499 002 OF 002

U.S. Financial Bailout Appears Misguided  
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17. (C) U.S. economic leaders are inexperienced in disposing of banks' bad assets, said, Liu, and could use advice from Chinese officials, who have been through several banking crises. The U.S. approach of providing additional liquidity to all banks is like a doctor prescribing additional food intake for a patient with cancer, said Liu -- the treatment does not match the disease. Instead, U.S. officials should isolate the problem loans and take them out of the banks, much like cancer is cut from a patient. Specifically, Liu said that the U.S. Government should purchase defaulted mortgages from among what he estimated to be the total US\$10 trillion in U.S. mortgages; purchasing the derivatives based on these bad assets was not getting to the root of the problem.

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Shanghai Recruiting Financial Professionals on Wall Street  
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18. (C) Liu said that Shanghai has organized a trip to Wall Street to help local officials recruit financial professionals; Shanghai-based state-owned enterprises have also been invited to join the delegation. Liu strongly approved of this move, saying that Shanghai should be more open to overseas personnel to improve the local business environment.

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